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DEPARTMENT FOR AF/S AND INR

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SUBJECT: DEVELOPMENT PARTNERS' CONSULTATIVE FORUM BRIEFED BY IMF MISSION

MASERU 00000414 001.2 OF 002

Summary

¶1. (U) On Tuesday, November 17, the United Nations Development Programme (UNDP) hosted the Development Partners' Consultative Forum (DP CF) briefing by the International Monetary Fund (IMF) mission on Article IV consultations. The IMF expects Lesotho's economic growth to be around 1.5% in 2009. The mission reported that the inflation rate was down 7.3% in September compared to last year. Productivity has declined in the Lesotho's leading economic sectors: agriculture, textiles, and mining. The IMF mission projects a large deficit in 2010/11 unless the government of Lesotho makes some policy changes regarding the budget.

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Inflation and Growth down, textile sector expected to contract further
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¶2. (U) The IMF reported that economic growth in 2008 was 4.5%. but in 2009, they expect the rate of growth to be around 1.5%, mainly due to the decline in global demand -- especially the demand for textile exports. The mission reported that Lesotho's inflation rate declined from 12% in September 2008 to 4.7% in September 2009. This decline has been driven mainly by lower food prices, which carry more weight in the Lesotho Consumer Price Index basket. According to the IMF, the agriculture and textile sectors' percentage share of GDP has been steadily declining. In addition to experiencing marked decline since 2006, the textile sector's productivity is expected to contract by 10% in 2009. The IMF advised the Government of Lesotho (GOL) that it needs to find ways to make this sector competitive in the world market, but they also recognize that the options are limited since Lesotho's textile sector pays higher wages than competitor countries such as Bangladesh. Lesotho's comparatively high wages also make it difficult to attract new investors, negatively affecting the competiveness of the country's exports. The IMF reported that Lets'eng mine production is still good despite the declining commodity prices and global demand. However, Liqhobong and Kao mines have suspended their operations until world commodity prices improve. Finally, the IMF recommended that GOL should diversify the country's production base into non-textile manufacturing.

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Budget deficit unsustainable, entire budget needs an overhaul
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¶3. (U) The IMF reported that Lesotho's 2009 budget, approved by Parliament in February, was highly expansionary, with a deficit of around 10% of GDP (Lesotho normally runs deficits around 3%, so this year's is quite high). The IMF had suggested earlier in the year that the Ministry reduce budget expenditures, since a deficit at that level is unsustainable. With the reduction in expenditure resulting from the revised budget and the slowdown in spending caused by Integrated Financial Management Information System (IFMIS) problems during the first half of the year, the IMF expects this year's deficit to total around 1%. (Note: IFMIS was introduced in 2009 and has had a number of technical problems since its introduction. Complaints have been rampant in the local press. Despite these initial problems, the system is expected to contribute to greater transparency and accountability in the management of public funds. End Note.) Almost 60% of Lesotho's current budget comes from South African Custom's Union (SACU) revenue. Lesotho received $657 million in SACU revenue in 2008/09. The figures have since been revised, and therefore, Lesotho has to pay approximately $146 million of the $657 million back to the SACU common revenue pool (CRP) in 2010/11. Due to SACU repayment and declining SACU revenues, GOL revenue is expected to decline by 17% of GDP in the next year. The IMF added that if the GOL makes no budget policy changes, the GOL will have a very high deficit in 2010/11. IMF did not predict how high the deficit might be.

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IMF Changes and SACU repayment considered, $17.72 million shortfall expected

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¶4. (SBU) The IMF mission made several recommendations to the GOL. First, the GOL must reduce government expenditure. Some

options are: Reducing the wage bill (a large percentage of government expenditure) by freezing all new staff positions and hiring below attrition; reducing expenditure on goods and services; giving no general wage increase for civil servants in 2010/11. Second, the GOL should budget on an outturn basis instead of by appropriation. Third, the GOL should negotiate a payment schedule for SACU revenue overpayments from 2008/09, allowing them to pay when the GOL's fiscal position has improved. Finally, the GOL could use part of its foreign exchange reserves to help deal with the implications of the budget deficit. When deciding the total amount of reserves that can be used, the GOL will have to ensure that the minimum international reserve requirement remains in the bank to keep the Lesotho loti pegged to the South African rand. Additionally, Lesotho is being required to make a M1.1bn (about $150m) repayment to the South African Customs Union (SACU) in ¶2010. Even if the GOL is able to make all these adjustments and meet this repayment, there wQld still to be a financing gap of approximately $17.7 million. The IMF urged development partners to consider helping the government close this financing gap through budget support.

(Comment: It is unlikely that GOL will be able to implement all the recommendations made by the IMF, especially the repayment of SACU revenue because that decision involves other countries. The $17.7 million financing gap is the best case scenario assuming all the recommendations can be implemented. Post believes the financing gap would be well in excess of the $17.7 million.)

Future prospects

¶5. (U) In the long term, among the challenges, the IMF foresees some bright prospects due to the construction of Metolong dam, which is expected to start in the middle of 2010. Developments in phase II of the Lesotho Highlands Water Project, with construction of the Polihali Dam at Tlokoeng in Mokhotlong, are

also expected to boost economic activity in future years.
NOLAN